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SUBJECT: PROPOSED GOC TAX ON HARD CURRENCY EARNINGS:
FINANCIAL REFORM OR RESPONSE TO CASH CRUNCH?

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Classified By: COM Michael E. Parmly for reasons 1.4 (b) and (d)

¶1. (U) Beginning in early January, 2008, the GOC will tax previously undeclared salaries paid to Cubans employed by foreign companies. These employees officially work for the GOC entity CUBALSE, which receives payment for them from the foreign companies and passes a minimal amount on to the employee, but earn most of their income from separate, direct payments from the companies. Accordingly, foreign companies -- mainly joint-venture partners with state companies -- will have to declare these salaries for the first time, making them part of accounting records not normally subject to GOC scrutiny.

¶2. (C) These previously-undeclared salaries are actually "under-the-table" salaries paid by foreign companies to ensure the livelihood of their Cuban workers, given that their official salary -- which is a fraction of what the foreign company pays the GOC directly for their services -- is not enough to live on. Most foreign entities in Cuba carry out this practice, as do foreign diplomatic missions including USINT. Although the full text is yet to be published, Foreign Investment Minister Marta Loma said the measure is meant to, "Normalize relations between foreign investors and Cuba."

Comments:

¶3. (C) The "under-the-table" salaries are among the main draws that motivate Cubans to leave their state jobs and flock to joint-venture jobs where their meager state salaries are complemented by more attractive hard-currency payments. Heretofore, however, these have been unaccountable to the GOC. The new measure could be justified by the GOC's long-running anti-corruption campaign as well as its more recent attempts to improve discipline and accountability throughout the economy. By holding joint-venture partners accountable, the measure would impose some transparency on the practice. However, contacts in the hotel industry and other diplomatic missions have told us they believe the GOC is really taking this action because it needs to raise cash. This theory was given further credence recently when CUBALSE, the GOC entity that officially employs our LCN staff (and all other employees of diplomatic missions and international corporations) approached USINT and asked that we alter our regular payment to them by reducing the number of reported leave days taken by LCN employees and instead spread those hours over the next several months. The result would be a significant increase in our December payment to CUBALSE. When our budget office refused to go along with this bit of accounting chicanery, the CUBALSE officials became very angry.

¶4. (C) Whatever the motivation, the measure would also make it more costly for foreign companies to continue the practice and could therefore become an incentive to do away with "under-the-table" salaries altogether. If this were to happen, the GOC would have effectively withdrawn one of the main incentives for Cubans to leave their state jobs--a problem that has been recently reported by the GOC press, particularly affecting many teachers who have been leaving the education sector in droves.

¶5. (C) In light of current GOC plans to open up to more investment, it is unclear what effect the measure will have. However, if the practice of hard-currency salaries remains even after taxes, a fatal flaw in the GOC's socialist -- egalitarian -- economic model will be fully exposed: Some Cubans are paid significantly more than others. It is unlikely that the GOC will be capable of fully monitoring and accounting for all or even most "under-the-table" salaries. Rather, inferring from usual GOC implementation, enforcement of the new measure will more likely be uneven and imperfect, making it harder to eradicate what could become legal and acknowledged income inequality in Cuba.

¶6. (C) Foreign companies would likely only increase salaries if worker productivity were to increase. But because salaries are to be taxed, one effect is certain, regardless of the level of enforcement. Cubans working in joint-venture companies will receive either lower declared salaries (because they are to be taxed) or lower undeclared salaries (because the GOC will no longer disregard the practice, to continue the practice would be more costly). Lower salaries will mean a smaller performance incentive, which would equate to poorer services and lower productivity, precisely the opposite effect of that desired by the GOC. In his July 26, 2007 speech, Raul Castro spoke of the need--and his desire--for greater foreign investment in Cuba, so long

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as that investment is respectful of Cuban sovereignty. Foreign business contacts who briefed us on the new regulation commented--tongue in cheek--that either Raul has a funny way of showing his open attitude, or he is not fully in charge. Those are both valid possibilities.

PARMLY